

Economic crisis in East Asia: the clash of capitalisms

Chalmers Johnson*

The Asian economic model does not exist uniformly in East Asia and is itself only a model, not the complex economic reality of a huge and diverse area. 'Crony capitalism' is an inadequate explanation for what has happened in East Asia. And in the debate between Anglo-American economic orthodoxy and revisionism, the meltdown has tended to confirm the results of revisionist research. There are three main contenders among explanations for the meltdown—all three of which may prove to be true. These are the liquidity-crunch explanation, the overcapacity explanation, and the end-of-the-Cold-War-in-East-Asia explanation.

For the past six months Americans have been told repeatedly that the Asian economic model is obsolete and that the meltdown in East Asia will not affect them, their jobs, or the American stockmarket. Even the 1997 US trade deficit with Asia of well over \$100 billion is considered good news because cheap imports will keep down inflation. But what is at risk in East Asia is the real possibility of a global collapse of demand and another Great Depression. Even if that does not happen, America's system of rich satellites serving as hosts to an expeditionary force of some 100,000 US troops is virtually certain to come to an end.

Something very serious has happened in East Asia. But the causes are so complex and so few agree on them that any prudent observer should be very careful about making overly quick judgements. There are at least three caveats that must precede any discussion of the details of the so-called meltdown.

First, the Asian model does not apply evenly across East Asia. For the sake of discussion and simplification, I think of the East Asian model as consisting of Asian values on subjects such as the nature of government, priority given to the community over the individual, and government guidance of a nonetheless privately owned and managed market economy, with economic growth tied above all to exports. This contrasts with the Anglo-American emphasis on what Westerners claim are (or should be) universal values: individualism and *laissez-faire*, with economic growth tied above all to domestic demand. In terms of the countries affected by the meltdown, the Asian model really only applies to Japan and South Korea. It never existed in Thailand or Indonesia—that is one reason why they were the first to crash under the speculative pressures against their currencies. It is only incipiently relevant to mainland China or Vietnam. And although the Malaysians

Manuscript received 3 March 1998; final version received 17 June 1998.

*Japan Policy Research Institute, Cardiff, CA, USA.

talk a great deal about Asian values, they violated the tenets of the Asian economic model by allowing Japanese, European, and American banks to export their own versions of the bubble economy to Malaysia. The Asian economic model is alive and flourishing in Taiwan, the Hong Kong Special Administrative Region of the People's Republic of China, and Singapore, and it seems about to take hold, now that the Americans have finally left, in the Philippines. In the minds of most Asians, particularly the Chinese, the meltdown has, if anything, reinforced the need for the Asian model of development rather than repudiating it. Linda Weiss, in her new book *The Myth of the Powerless State* (1998) offers the best analysis of the differences between the North-east Asian transformative states and the South-east Asian pilotless states.

The second caveat is that an explanation of the meltdown in terms of 'crony capitalism' is wildly overdrawn. I take crony capitalism to mean corruption, nepotism, excessive bureaucratic rigidity, and other forms of trust violation that can occur whenever a state tries to manipulate incentives or, in other ways, alter market outcomes. The system of tax deductions for household mortgages in the US is a standard example of this form of state guidance of the market.

Crony capitalism is said to promote many sins, including the overbuilding of real estate throughout the region and the excessive importing of consumer goods, such as luxury cars—that is, the kinds of things the Mexicans did a few years ago when foreign financial institutions poured money into their country. But foreign loans to South Korea did not go into real-estate investment, and what has been wrong in Thailand and Indonesia was precisely the lack of a pilot agency, such as Japan's Ministry of International Trade and Industry, to keep such practices under control. The most glaring instance of nepotism affecting an economy in East Asia has been under General Suharto in Indonesia, who is, we hope, the last of the Marcos-style Asian dictators that the Americans have always preferred and supported. The ultimate in crony capitalism is actually the US-dominated International Monetary Fund (the IMF) and its bailing out of Thailand, Indonesia, and South Korea; the IMF's money does not go to the people of those countries. It goes to the foreign banks that made too many shaky and imprudent loans to Thai, Indonesian, and South Korean banks and businesses in the first place.

In 1994 South Korea, in an attempt to follow the nagging of its patron, the United States, abolished the Economic Planning Board, Korea's main body for making economic policy since the early 1960s, and loosened virtually all controls over financial institutions. In return for these self-inflicted wounds, Korea was admitted to the club of rich nations, the Organization for Economic Cooperation and Development (OECD), with its headquarters in Paris. As a direct result of these 'reforms', the government failed to monitor properly the foreign borrowing activities of inexperienced merchant banks. But the situation in Korea differs greatly from that in South-east Asia. With the election of a new, anti-establishment president in South Korea, Kim Dae Jung, the country is using the meltdown as a cover for ruthlessly killing off its weak conglomerates while strengthening and rationalising the big ones. Because of his credentials with the trade unions, President-elect Kim will probably manage to restrain labour by promising it a leaner, meaner Korean industry in the future. South Korea's re-emergence as an economic powerhouse will also smooth the way for unification with the North, without interference from the US, China or Japan.

Throughout the region, the current crisis was caused much more by under-regulation than by corruption or any other side effects of an overly close relationship between businesses and the government. What all these places need is neither more nor less regu-

lation but effective, expert guidance of the sort Japan and South Korea exercised during their periods of high-speed economic growth.

Only Japan truly fits the crony capitalism description. Ever since Japan's bubble economy started to deflate in 1989 and 1990, Japan has complacently continued to protect its structurally corrupt and sometimes gangster-ridden firms and has made only gestures toward holding anyone responsible. Virtually all of its public funds to stimulate the domestic economy have gone to the politically powerful but environmentally disastrous construction industry. Japan has been able to get away with palliatives largely because of the perpetuation of Japan's cosy Cold War relationship with the United States. This means that Japan is not being forced to make the painful choices that adjusting to a global economy would require. Japan remains today essentially a protectorate of the United States, not fully in charge of its own government or destiny. When that changes, Japan will change.

In the meantime, it is well to remember that crony capitalism was not the intent but a by-product of the structural characteristics of the Asian-type economies. These structures include cartelisation of the *keiretsu-chaebol* variety, bank-based systems of capital supply, mercantilism and protectionism *vis-à-vis* external economies, and rule by bureaucratic elites despite a pretence of democracy. The intent of these structures was to enrich the nations of East Asia, not to meet consumer demand, global efficiency, individual choice, or any of the other motives posited by neoclassical economics. That they succeeded so spectacularly during the historical era known as the Cold War altered the world balance of power.

Over time crony capitalism has become a serious side effect of Japanese-type economies, but its economic costs can easily be exaggerated. The United States's strong economic performance during the 1990s coincided with the biggest outbreak of American crony capitalism since the arrival on the scene of the military-industrial complex during the 1950s. Yet no one is proposing a total restructuring of the American economy because the Lippo Bank of Jakarta tried to buy influence in Washington, or despite evidence of the sale of ambassadorships and burial plots in Arlington National Cemetery, or military budgets bigger than all the United States's allies and potential enemies combined. John Carlin in *The Independent* (24 May 1998) describes the United States as 'the most legally corrupt political system in the world'. If crony capitalism brought down East Asia, why has it not similarly affected the United States, where it seems to be endemic?

The third caveat about the Asian meltdown concerns the widespread criticism that foreign analysts of East Asian capitalism failed to predict it or even to perceive the shadowy side of the East Asian model. This criticism is directed particularly against the so-called 'revisionists' and their books on the Japanese economy (including writers such as James Fallows, Clyde Prestowitz, Karel van Wolferen, and myself). These writers are now routinely lumped together with the Chrysanthemum Club of Japan apologists and accused of wishful thinking about Asia. For the editorial boards of the *Wall Street Journal* and the London *Economist*, together with virtually the whole tenurocracy of professors of economics in the English-speaking countries, the news of the East Asian meltdown has come as a gift from heaven. They see it as a massive vindication of their neoclassical economic orthodoxy. But has revisionism been repudiated? I think not.

It was the so-called revisionist writers who first outlined the differences between East Asian and American capitalism. During the early 1980s, when Japan's trade surpluses with the United States set new records every month and came close to destroying vital parts of the manufacturing base of the American economy, the revisionists warned that

this situation was not the result of 'invisible hands' guiding market outcomes but of 'capitalist developmental states' engineering high-speed economic growth. The revisionists advocated using the full market power of the United States—which was and still is the main market for all the East Asian economies—to force them to make international trade mutually beneficial by opening their markets.

During the Reagan, Bush, and Clinton administrations, American elites listened to the revisionists' message, but they did something else. In the Reagan era, they had become too dependent on Japan's savings to finance their combination of tax cuts and rearmament to confront Japan directly. Therefore they set out to cut the trade imbalances by manipulating the exchange rates of the US dollar and the Japanese yen. This was good neoclassical economics but abominable Japanese area studies. In order for a cheap dollar and an expensive yen to make a difference, the primary problem between the two countries would have had to have been competition on prices. But the real issue was that Japan's markets were closed to foreign investors and retailers, as well as cartels, lack of enforcement of trade agreements, sham antitrust laws, and a host of other practices that Japan had perfected over the previous 40 years.

The results of the United States pursuing an exchange-rate approach to the problem of trade with Japan were profound. They made no difference to the trade imbalance, but they stimulated Japan to undertake countermeasures to the high yen, which led to Japan's bubble economy, then to the collapse of the bubble economy, then to Japan's export of its bubble economy to South-east Asia, and finally to the economic meltdown that confronts us today. What Japan needed was to develop an economy that relied more on domestic demand than on exports. But Japan's answer to the high yen was wild overinvestment to enlarge productive capacity in order to continue exporting to any and all markets.

This is, of course, not what the revisionists advocated. A stronger case could be made that the current economic crisis threatening the entire world—it is certainly the worst such crisis since the OPEC oil price hikes of 1973—came about because too many rich nations knew next to nothing about the nations of East Asia. The Anglo-American economies refused to heed in a timely fashion the extraordinary imbalances, dependencies, and irresponsibilities that the East Asian capitalist developmental states were creating. Western economists, unable to explain Japan's growth or, for that matter, even to read a Japanese newspaper, rejected so-called revisionism because its findings were incompatible with orthodox neoclassical economic theory. The disaster of 1997 did not refute revisionism but rather confirmed the essence of the revisionists' message—there are differences among capitalist systems that are not trivial and that under certain circumstances can blow the system apart.

But the revisionists did not get the whole story right. Above all, they did not analyse correctly the Cold War context of East Asia's enrichment. They knew that the United States's chief contribution to this enrichment had not been its wars, its military deployments or its diplomacy, but rather its markets. The Americans bought the high-quality, low-cost manufactured goods of East Asia in greater quantities than any other external market. The revisionists understood that Asia's rigged economies depended to a critical extent on access to the American market and that they would all be in trouble if and when the US ceased to play the role of market of last resort. But they did not understand how the collapse of the Soviet Union, the end of bipolarity, and the tendencies toward globalisation of finance and manufacturing would expose the contradictions in the American–East Asian relationship. The revisionists, like virtually all Western analysts, were intellectually captives of the separation of economics and politics, of trade and defence,

that has for so many years dominated all thinking about the role of the United States in East Asia.

The events of 1997 were the first developments that would force an end to the artificial distinction between trade and defence and cause Asians and Americans alike to begin to look with clarity at the political, military and economic relations that lie behind the Asian meltdown. Thus far in the crisis, the United States has been willing to tolerate growing trade deficits as the stricken economies of East Asia try to export their way out of their troubles. But as Japan's refusal to help by opening its own markets, and even its competing with the stricken economies in exporting to the US, become common knowledge, the pressures to protect the US market will become intense. A concomitant will be a rethinking of American military strategy in East Asia, possibly beginning to bring to an end Japan's status as the most privileged satellite of the US in the area.

The Asian economic model does not exist uniformly in East Asia and is itself only a model, not the complex economic reality of a huge and diverse area. Crony capitalism is an inadequate explanation for what has happened in East Asia. And in the debate between Anglo-American economic orthodoxy and revisionism, the meltdown has tended to confirm the results of revisionist research. Like the caveats, there are also three main contenders among explanations—all three of which may prove to be true. I call these differing views the liquidity-crunch explanation, the overcapacity explanation, and the end-of-the-Cold-War-in-East-Asia explanation.

The liquidity-crunch explanation asserts that the current East Asian crisis is essentially a financial problem rather than a crisis of the 'real economy'. Given a globalised financial system overloaded with money and a lack of elementary prudence on the part of borrowers in Thailand, Indonesia, Malaysia, and South Korea, these countries, starting in about 1994, borrowed hundreds of billions of dollars from foreign lenders. They invested these funds in sometimes foolish projects, such as fancy apartment and office buildings, or in export industries that were soon crippled by overcapacity. They believed, without truly analysing the matter, that their export industries would continue to grow and remain in their countries indefinitely, even though jogging shoes—to name one example—were once made in South Korea, then Indonesia, and now China and Vietnam. Businessmen in these countries also believed that, in the context of a continuously growing economy, their governments would help out any particular bank or conglomerate that found itself running out of money to pay back the loans.

But in July 1997, starting first with Thailand, foreign lenders began to realise that some of their Asian clients could not repay their loans. This caused other foreign investors to start withdrawing huge amounts of money from both poorly managed and completely healthy enterprises. Given globalised financial markets, the instantaneous transmission of data to anyone who wants it, and a lack of effective safety-valves, the crisis rapidly spread all over Asia. It raised the possibility of runs on banks even in the world's second largest economy, which is also the richest in per capita terms and the major source of long-term capital for the world—namely, Japan. The foreign lenders, big banks such as Citicorp and J. P. Morgan, had made the loans because the four international bail-outs of Mexico since 1976 taught them that, so long as they lent money to countries that were part of the informal American empire, they could expect the American government or some surrogate of it such as the IMF to step in and make good on their so-called non-performing assets.

The crisis was exacerbated not just by gullible borrowers and complacent lenders but also by some developments among the great powers that have been largely overlooked. In

the last ten years China's share of East Asia's exports to the US market has grown from 6% to 26%. Even more important, in 1994 China devalued its currency by 35%, thereby making its exports hypercompetitive with those of South Korea and South-east Asia.

Something similar to the emergence of China as a competitor occurred elsewhere in the summer of 1995. The American Treasury and the Japanese Ministry of Finance agreed on a deal intended to help re-elect President Clinton the following year and to allow Japan to grow its way out of its own, post-bubble banking crisis via the usual export drive. Robert Rubin for the Americans and Eisuke Sakakibara for the Japanese decided between themselves that they would depreciate the yen against the dollar, thereby greatly increasing Japan's export competitiveness, in return for which Japan would continue to supply capital to the United States, thereby keeping American interest rates at politically desirable low levels. The American government also agreed to end its plan to put duties on imported luxury cars from Japan, keep quiet about America's billion-dollar-a-week trade deficit with Japan, and shift the focus of the Japanese-American alliance away from economic relations and back to security issues, even though there were no threats to security in the region.

Between April 1995 and April 1997, the yen fell 60% against the dollar. That alone priced most economies of South-east Asia out of the market. Thailand still tied the exchange rate of its own currency to the now seriously overvalued dollar and was ruined as a result. Given the overcapacities that too much investment generated and the competitive challenges from China and Japan, export growth in South Korea and in the ASEAN countries fell from 30% in early 1995 to zero by mid-1996. A balance-of-payments crisis was inevitable.

When the loans started to come due in the summer of 1997, the logical, economic-textbook response of the borrowers should have been to default and declare bankruptcy. That would have seriously pained the lenders, teaching them what markets are supposed to teach—that one is responsible for the risks one assumes. The foreign bankers would have had to renegotiate their loans to the East Asian countries, spreading them out over time and also adding a few profitable points to their interest rates. The Western and Japanese banks would probably never have got all their money back. However, under this scenario, the people who lost financially would have been the investors in the G-7 democracies, not the people of Asia; and reform of the East Asian economies would have been forthcoming because of market forces, not orders from Washington. Many Asian and American bankers and politicians would have been sacked, but the people of East Asia would have accepted the need for long overdue reforms and would have implemented them much more willingly.

What was actually done turned a liquidity crisis into a full-blown economic disaster. At first the Japanese stepped forward and said that they would provide at least some of the money in order to redeem their fellow Asian's debts. They proposed a new multinational financial institution led by Japan and restricted to making loans to Asian countries. The Americans instantly objected. They correctly sensed that Japan was about to try its hand at long promised but never delivered international leadership. If the Japanese had succeeded, they would have slipped the leash of the American Cold War system. Moreover, they would have started using their surplus capital to help countries in Asia rather than continuing to send it to the world's number one debtor nation, the United States. If the Americans ever have to finance their own stupendous debts rather than depend on Japanese savers, American interest rates will soar to double-digit levels. At the 19 November 1997 meeting in Manila where the newly proposed Japanese institution was

quietly put to sleep, the Americans' point-man, Deputy Treasury Secretary Lawrence Summers, declared himself pleased that the clean-up was to be entrusted to the IMF. Japan's vice-minister of international finance, Eisuke Sakakibara, commented *sotto voce* that he and others still believed the IMF was not up to the task. He turned out to be right.

The IMF is an old Bretton Woods institution set up in 1944 to service the system of fixed exchange rates that lasted until the 'Nixon Shocks' of 1971. It survived its loss of mission to become, in Robert Kuttner's words, 'the premier instrument of deflation, as well as the most powerful unaccountable institution in the world' (*Boston Globe*, 4 January 1998). It is also an instrument of American power, one that allows the United States to collect money from its allies and to spend the amassed funds on various international economic operations that serve American national interests.

The IMF roared into Asia and promised to supply \$17 billion to Bangkok, \$40 billion to Jakarta, and \$57 billion to Seoul. In return it demanded austerity budgets, high interest rates, and sales of local businesses to foreign bargain-hunters. It claimed that these measures would restore economic health to the 'Asian tigers' and turn them into orthodox Anglo-American-type capitalist economies.

There was almost no chance that the IMF's one-size-fits-all remedies would succeed. Its economic ideologues not only know nothing about East Asia, they believe there is no *need* for them to know anything. Totally devoid of concepts of culture or of cultural differences, the IMF did not know that it was undercutting Korean housewives' investment co-ops with their millions of untaxable funds, or that the Indonesian government's subsidies go towards food and fuel, not just to cronies of Suharto. Not surprisingly, Asian editorial writers started to write essays with titles like 'The Second Opium War' and to mutter about American imperialism. Meanwhile, the social chaos that Western advisers produced in post-communist Russia seems just around the corner in Asia.

The second explanation of the meltdown, that it was caused by overcapacity, follows directly from the first but has much more ominous implications. The difference is that the first explanation stresses Asia's short-term indebtedness problems, whereas the second explanation says that, regardless of the rather obvious financial problems, the Asian economies do not rest on good fundamentals. The Asians may save a lot, keep their children in school longer than anybody else, and recruit smarter state bureaucrats than Washington does, but they are catastrophically overinvested in the wrong industries—principally cars, shipbuilding, steel, petrochemicals, and semiconductors. This explanation also explicitly includes Japan as part of the Asian problem.

Because Japanese, European, and American multinational corporations have also moved so much of their manufacturing to places where skilled workers are paid very little, these new workers cannot possibly consume what they produce. But the consumers back in the G-7 democracies also cannot buy much more because either their economies are stagnant or they have just lost their jobs. The financial difficulties that the IMF is trying to deal with are only a symptom of a more serious disease. The underlying danger is a structural collapse of demand leading to recession and ultimately to something like the Great Depression. As William Greider has put it in his *One World, Ready or Not*, 'Shipping high-wage jobs to low-wage economies has obvious, immediate economic benefits. But, roughly speaking, it also replaces high-wage consumers with low-wage ones. That exchange is debilitating for the entire system' (1997, p. 221).

It is one thing to have IMF bungling cause a recession in East Asia; it is quite another to have a huge overcapacity to manufacture things that no one wants or can afford causing a recession. If the meltdown of 1997 represents manufacturing capacity that can never

recover its costs, then the world requires the direct opposite of the policies the IMF is pursuing today in East Asia. It requires the creation of new demand, not the deflation of the demand that exists at the present time.

The third explanation—the end of the Cold War in East Asia—relates to the second in that it starts by asking how so much overcapacity came to be built in East Asia in the first place. One answer is that the economies of Japan and South Korea have been rigged since early in the Cold War in order to serve the grand strategy of the United States against communism in Asia and to ensure that they did not toy with neutralism or socialism. Many other places in East Asia, including Taiwan, Hong Kong, Singapore, Thailand and the Philippines, were outposts of American capitalism, protectorates, or recently closed bases of operation for America's wars. The Cold War deal the Americans offered to keep these satellites in line was unrestricted access to the American market, toleration of their mercantilism and protectionism, and technology transfers at often concessionary prices in return for public anti-communism and basing rights. (There are still 100,000 American troops based in Japan and South Korea and the US Seventh Fleet patrols the waters of East Asia.)

The Cold War ended in Europe in 1989 when the Soviet Union allowed the people of Berlin to tear down the wall that divided their city. It is possible that what happened to the Soviet Empire in Eastern Europe in 1989 started to happen to the American empire in East Asia in 1997. The difference is that in Eastern Europe the Soviet Union's satellites wanted to end their deal with the Russians, whereas in East Asia the American satellites still want to remain in their deal with the US. As far as Japan and South Korea are concerned, they have kept their side of the bargain—the American bases are still on their soil and they are still paying for them more generously than any other American allies around the world. (In Japan's case, the bases are on Okinawan soil that the US and Japan collaborate in keeping dependent.) What the two systems of satellites have in common is that neither the Russians nor the Americans can afford them any longer. Even if he might later have regretted it, in 1989 Gorbachev decided that he could no longer afford to keep the Red Army based in East Germany, Poland and the former Czechoslovakia. The Americans have not yet acknowledged that they cannot afford their satellites in East Asia. But either because of fiscal constraints or because their currency has depreciated so badly, the Japanese and the South Koreans cannot continue to pay for the upkeep of American troops on their soil or buy the panoply of American weapons that the Pentagon wants to sell them. Already the Thai government has had to cancel its purchase of eight American-made F/A-18 fighter jets, and South Korea does not have the money to pay for the power reactors promised to North Korea. The more the Americans succeed in forcing the Asians to revamp their economies, the more independent the Asians will become of American influence.

What is to be done? That depends on which explanation you accept. If it is the first, then the answers are fairly straightforward. Stop the IMF before it turns a problem into a disaster and implement some elementary controls on capital movements. The idea is to end the volatility of hot money. A tax on short-term loans of 2%–3% would have the same effect. Government regulations could also favour direct foreign investment over purchases of shares of stock. An appropriate regulatory regime would be one that inhibits short-term investments and discourages local businesses from accumulating big debts in foreign currencies. It is absolutely certain that China, so far relatively insulated from the meltdown by the lack of convertibility of its currency, will be experimenting with these types of control over the coming years.

If one accepts the overcapacity explanation, then the US should start using the full power of the American market to raise the wages of workers in places where multinational companies are investing, so they can purchase new products more or less on a par with employed American workers. The collapse of demand that caused the Great Depression was ultimately overcome only by war production for the Second World War. The better way is to stimulate demand among poor people by increasing their incomes.

If one accepts the third explanation, then the Americans must finally let the Cold War end. This will have the effect in East Asia of forcing economically powerful countries such as Japan and South Korea to start coming to grips with the real challenges of the next century—the unification of Korea, adjustment to the emergence of China, avoidance of ethnic and religious violence in South and South-east Asia, and mitigating environmental degradation. Failure of the United States to adjust to its status as an ordinary country will only expose it further to imperial overstretch and Soviet-style decline. Certainly, the US should continue to push for economic reform in countries like South Korea and political reform in countries like Indonesia. But these will make no difference without reform and greater independence in Japan. And no amount of foreign money or pressure will cause Japan to reform. Only cutting its apron strings to the US will energise the Japanese political system. If that happens, we are likely to see a renewed burst of growth and prosperity throughout the region. If not, global recession is a serious possibility.

Bibliography

- Fallows, J. 1994. *Looking at the Sun: The Rise of the New East Asian Economic and Political System*, New York, Pantheon
- Greider, W. 1997. *One World, Ready or Not: The Manic Logic of Global Capitalism*, New York, Simon & Schuster
- Johnson, C. 1982. *MITI and the Japanese Miracle: The Rise of Industrial Policy, 1925–1975*, Stanford, CA, Stanford University Press
- Prestowitz, C. 1988. *Trading Places: How We Allowed Japan to Take the Lead*, New York, Basic Books
- Weiss, L. 1998. *The Myth of the Powerless State: Governing the Economy in a Global Era*, Cambridge, Polity Press, and Ithaca, New York, Cornell University Press
- Wolferen, K. van. 1989. *The Enigma of Japanese Power*, New York, Knopf

